Fourth Quarter 2016
Quarterly Letter to Clients
By Scott A. Wendt, CFA
January 20, 2017

As the champagne glasses clinked to toast in the New Year, we bid farewell to an unforgettable 2016. It was a year of transition and confusion. It was a year where we experienced a vast range of economic, social, and political changes. It was a year where the economy continued its muted growth pattern, despite the best efforts of policy makers. It was a year that sent tremors and quakes that moved the tectonic plates of public opinion, leaving behind unexpected political landscapes around the globe. Indeed, it felt like a year out of an 1850's Charles Dickens novel, where the turn of events brought both unexpected joy and despair.[1] While 2017 will undoubtedly have its share of challenges, this letter will try to provide some insight regarding the current investment environment and a summary of how your account has performed during the last few quarters.

As the U.S. economy logged its 90th month of growth at the end of the 4th Quarter of 2016, it is quickly approaching the record for the third longest expansion in the 120 years of records kept by the National Bureau of Economic Research (NBER). The average expansion over this same period is 47 months, putting the current age of this upturn in the "senior citizen" category. The limitations of the current economic expansion appeared to have changed with the election of Donald Trump for President, as the hope for regulatory and tax reform energized the imagination of market participants. However, it is difficult to see how the fundamentals of an economy that has grown at such a subpar level for so long are going to shift gears to provide above average growth in the near term, given the myriad of possible outcomes from domestic policy changes and global responses to those changes.

The consumer continues to be the primary driver of the U.S. economy, accounting for the majority of the growth in Real GDP over the past few years. Improvements on the labor front and gains in disposable income have combined to allow consumption to grow at about a 2% annualized rate. Unemployment continues to hover just under 5%,

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[1] See Charles Dickens's A Tale of Two Cities, London: Chapman and Hall, 1859. First edition. *"It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness, it was the epoch of belief, it was the epoch of incredulity, it was the season of Light, it was the season of Darkness, it was the spring of hope, it was the winter of despair…"*

while the rate of job growth is beginning to fade. The hope of reversing the low labor participation rate of 62.3% rests in maintaining at least an average level of job growth. However, declining job growth implies that the employment picture may, statistically speaking, be nearing the level considered by economist as full employment. This is occurring at a time when two larger segments of the economy, housing and autos, are beginning to face some stronger headwinds.

The housing sector has benefited from a better employment picture and lower interest rates, both of which aided qualified homebuyers in completing purchases of new and existing homes. However, the spike in interest rates that occurred in the weeks after the election and higher home prices have conspired to reduce affordability for many would-be homeowners. Housing starts fell sharply during the past quarter and sales of existing homes began to exhibit a slowing trend. On the auto front, robust sales during the year have pushed annual units sold to 17.7 million, which are near peak levels and significantly above the long-term average level of 15.5 million units. However, inventories at the dealer level are slowly rising. This trend mirrors the general manufacturing and trade inventory levels, which remain higher than average. Together these trends indicate weakening demand and mean that manufacturers will need to produce less in the near term while working off excess inventories.

Additionally, the manufacturing sector is facing the double impacts of softening global trade and a rising U.S. Dollar. Increases in protectionist attitudes and softening demand from Asian economies over the past few years have combined to reduce global trade to under a 3% growth rate, which is less than half of the long-term growth rate experienced over the past 30 years. Slowing exports will directly influence capacity utilization for many U.S. producers, delaying the need to spend on new plant and equipment until demand returns to significantly higher levels.

Politics and the Federal Reserve pretty much dominated the investment landscape during the past quarter. Investors are facing an economy in the throes of transition and with the appearance that Presidential policies will take over carrying the baton of influencing economic activity from the Federal Reserve. However, given the challenges of a world in flux, the President-Elect's ambitious proposals to reignite growth and refocus America's priorities face some significant challenges. In turn, the Fed has signaled its intent to begin, what is in essence, a long and drawn out process of reducing monetary stimulus and returning rates toward more normal levels.

The President-Elect has a large agenda and will have to simultaneously lubricate and turn the rusty wheels of the Washington bureaucracy, while pushing Congress to work

in a bipartisan fashion to achieve the promised outcomes. The first 100 days should be a whirlwind of activity as he tackles his major agenda items, including the following:

1. Repeal and replacement of the Affordable Care Act,
2. Regulatory reform,
3. Reducing and reforming tax rates,
4. Replace and improve infrastructure,
5. Revamping immigration enforcement and border controls, and
6. Renegotiating trade and tariff agreements.

There are upsides and downsides imbedded in each of these items, let alone many cross currents, that could result in numerous unintentional consequences. Nevertheless, change is coming. As always, the devil is in the details, which are not yet finalized.

While there are many expectations of change, the actual impact of these changes should probably be kept in perspective. For instance, reducing corporate tax rates and allowing the repatriation of U.S. dollar cash balances held in foreign subsidiaries should provide plenty of dry powder for U.S. Corporations to expand domestic operations. However, for companies to commit to increasing investment in new plant and equipment, they will need a combination of clarity of future government policy combined with increases in the domestic and foreign demand for the products that they make. This also assumes foreign governments do not take steps to retain manufacturing through additional tax reductions, credits, or tariff adjustments.

In a similar manner, the success of an ongoing infrastructure improvement program would provide a foundation for relocation of significant manufacturing capacity back to U.S. shores. However, the question remains: Would the quantity and quality of jobs that follow this relocation to the U.S. remain high, or would the lack of skilled workers necessitate the employment of technological substitutes (i.e. robots) to achieve the cost structure required to be competitive on a global scale? To complicate it just a little further, immigration policy may hold a key to meeting the future skill gaps in many industries, which could be the more important issue, as the need for a more highly skilled domestic labor force continues to fall short of employers' expectations.

Despite the uncertainty of the President-Elect's policy direction and the impact of a strong dollar, U.S. corporate profits have the potential to continue the positive earnings trends seen in the last half of 2016. After six negative quarterly earnings reports, the S&P 500 operating earnings trajectory reversed course, posting its first positive year-

over-year growth rate of +3.1% in the 3rd quarter of 2016. According to FactSet, analysts are estimating a +3.2% growth rate in the final quarter of 2016. [2] Earnings, and more specifically earnings growth, is an important factor in valuation of common stocks. Most analysts appreciate the shortcomings of market valuation indicators, which should not be used to time the market direction, but are useful in suggesting the magnitude of future potential changes. Though somewhat simplified, valuations that are significantly above the long-term average are deemed expensive and warrant caution, while those significantly below average are considered cheap and indicate the opportunity for better than average long-term expected returns.

Current valuations fit into the Goldilocks mentality of being "not too hot" or "not too cold" when compared to other investment alternatives. Most pundits' rationale goes along the lines that Price-Earnings (P/E) ratios *based on future earnings* are not that expensive when compared to the low returns expected in cash and fixed income securities. However, while most all investment professionals would agree that earnings growth is one of the important drivers of long-term stock returns, many would also agree that P/Es based on future earnings estimates are subject to the biases of analysts who are perpetually overly optimistic in their earnings estimates and repeated revise them downward as the year progresses. Thus, P/Es based on early estimates of future earnings most like value future earnings as a better value (lower P/E) than they really are. Estimates for 2017 through 2019 are going to be even more challenging and uncertain given the numerous potential policy changes we have already outlined (not to mention the normal "unexpected shocks" that seem to occur every year).

The valuation ranges depicted in the chart on the next page provide an example of the wide range of possible P/E ratios reported to investors. The chart, which appears daily in the **Wall Street Journal**, shows the three major Dow Indices P/E multiples using trailing 12-month earnings, as-reported earnings, and future estimated earnings. Like most current valuation measures, the ratios below are moderately to significantly above their comparative long-term average levels.

P/Es & Yields on Major Indexes

Dow Indexes

Wednesday, January 11, 2017

	P/E RATIO			DIV YIELD	
	1/11/2017†	Year ago†	Estimate^	1/11/2017†	Year ago†
Dow Industrial	**21.76**	15.34	18.68	**2.40**	2.75
Dow Transportation	**16.62**	12.01	16.06	**1.32**	1.64
Dow Utility	**27.82**	17.60	18.35	**3.45**	3.68

† Trailing 12 months

^ Forward 12 months from Birinyi Associates; updated weekly on Friday.

P/E data based on as-reported earnings; estimate data based on operating earnings. Sources: Birinyi Associates; WSJ Market Data Group

[2] "Earnings, Not Donald Trump, Are Stocks' Best Friend in 2017" by Akane Otani, **The Wall Street Journal**, 1/3/2017.

The bond and stock markets spent the majority of 2016 focused on the Federal Reserve and the potential timing for a shift in monetary policy, while keeping a proverbial eye on the unusual events surrounding the U.S. Presidential Election. Despite the pundits repeated prognostications and permutations on what was supposed to happen, we once again found ourselves in a topsy-turvy world where the unexpected became reality.

The bond market saw rates decline for the first half of the year, only to reverse and climb in anticipation of the Federal Reserve increasing rates sometime during the second half of the year. The 10-Year U.S. Treasury bond began the year at 2.24%, declining to a low of 1.37% and then recovering to a high of 2.60%, before finishing the year at 2.45%. In the past quarter, corporate bonds performed slightly better than high quality government bonds. Bonds with shorter maturities performed better than longer-dated credits.

Morningstar Bond Indexes — As of 12-31-2016

Broad Market	Quarter	1-Year	3-Year	5-Year
US Inter Core Bd TR Bond	(2.3)	2.2	3.2	2.6
US Lng Core Bd TR Bond	(6.9)	5.1	6.0	3.7
US Shrt Core Bd TR Bond	**(0.7)**	**1.5**	**1.1**	**1.1**
Corporate				
US Inter Corp Bd TR Bond	(2.3)	4.6	3.4	4.4
US Lng Corp Bd TR Bond	(4.8)	8.9	6.1	5.3
US Shrt Corp Bd TR Bond	**(0.6)**	**2.5**	**1.8**	**2.5**
Government				
US Inter Gov Bd TR Bond	(3.2)	1.2	2.3	1.3
US Lng Gov Bd TR Bond	(9.3)	1.1	6.3	2.4
US Shrt Gov Bd TR Bond	**(0.7)**	**1.0**	**0.8**	**0.7**

In spite of the significantly unusual times we are living in, the stock market provided very satisfactory results for the year. The table below displays the wide range of returns posted by mutual fund managers during several periods. For the quarter just past it shows that smaller capitalization stocks performed better than larger capitalization stocks. In addition, higher quality stocks outperformed their lower quality counterparts. On a total return basis for the quarter, the Dow Jones Industrial Average increased +7.9%, while the S&P 500 was up +3.8%. The tech-heavy NASDAQ posted a gain of +1.3%. The average mutual fund, represented as General Equity, saw a gain

of +4.1% for the quarter. International stock funds depreciated -0.7%. For the entire year, the Dow Jones Industrial Average rose +16.3%, while the S&P 500 Index climbed +12.0% and the NASDAQ gained +7.6%. Comparatively, the average diversified U.S. Stock Mutual Fund increased +10.8% for the year, while the average International Stock Mutual Fund was up +0.7%.

LIPPER MUTUAL FUND INVESTMENT PERFORMANCE AVERAGES

MONDAY, JANUARY 9, 2017

	Qtr	1 year	5 year	10 year
S&P 500	3.8	11.4	14.1	6.4
S&P 500 Index P	3.3	9.5	12.2	4.7
Dow Jones Ind. Average P	7.9	13.4	10.1	4.7
NYSE Composite P	3.1	9.0	8.1	1.9
General Equity	4.1	10.8	12.0	5.9
Equity Income	4.4	13.9	11.5	6.0
Large-Cap Growth	(1.2)	1.8	13.0	7.1
Large-Cap Value	7.0	14.6	13.3	5.0
Mid-Cap Growth	0.7	5.9	11.9	6.8
Mid-Cap Value	6.7	18.3	13.7	6.4

P-Price only index. Calculated without reinvestment of dividends. Source: Lipper

While the volatility of the capital markets will continually ebb and flow, our long-term investment philosophy will remain constant. Our goal is to find investments that will allow us to achieve your long-term objectives through a custom-tailored portfolio. We place a heavy emphasis on security selection, searching for those stocks that meet our investment standards, while still providing a purchase point with an acceptable margin-of-safety. We make every effort through this process to minimize the risks of permanent capital loss. The undertaking of discovering reasonably priced stocks, without sacrificing quality in a high and rising valuation environment, makes the task even more challenging. Nevertheless, we will continue to adhere to our investment discipline, irrespective of the market's oscillations.